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CITATIONS

In the Supreme Court of the United States

October Term, 1970

No. 883

United States of America, petitioner

v.

Edna Generes, wife of, and Allen H. Generes

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The district court did not render an opinion. The opinion of the court of appeals (R. 169-177)[1] is reported at 427 F. 2d 279.

JURISDICTION

The judgment of the court of appeals (R. 178) was entered on May 25, 1970. By order dated August 14, 1970, Mr. Justice Black extended the time for filing a petition for a writ of certiorari to and including Octo-

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[1] "R." references are to the separately bound record appendix.

ber 22, 1970. The petition was filed on October 21, 1970, and certiorari was granted on March 22, 1971 (R. 179). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether a shareholder-employee who is unable to collect a debt owed him by his corporation is entitled to a business rather than nonbusiness bad debt deduction if, as the court below held, the undertaking was motivated to a significant degree by his business interest as an employee, or whether, as the United States contends, such a deduction is allowable only if the dominant motivation for the undertaking was his employee interest, rather than his nonbusiness interest as a stockholder.

2. If, in the alternative, a significant employee motivation is sufficient to justify business bad debt treatment, whether, as the United States contends, there was no such motivation in the instant case under any workable definition of that term.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 and of the Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*, pp. 35-37.

STATEMENT

Respondent[2] and his son-in-law (Kelly) each owned

[2] References to "respondent" are to Allen H. Generes. Edna Generes is a party here because joint income tax returns were filed for certain of the years in issue.

44 percent of the stock of Kelly-Generes Construction Co., Inc., a corporation engaged in heavy construction work, principally for various governmental authorities. The remainder of the stock was owned by a son and another son-in-law of respondent. The corporation had been organized by Kelly and respondent in 1954 as successor to a partnership in which they were equal partners. Kelly, named vice president of the corporation, was in charge of its day-to-day operations and received a salary of $15,000 per year. Respondent held the office of president of the corporation, but spent only six to eight hours a week on its affairs, principally in obtaining bank financing for corporate activities and in securing performance and bid bonds on construction jobs undertaken by the corporation. As president, he received an annual salary of $12,000. In addition to being president of Kelly-Generes, respondent held a full-time position as president of a savings and loan association of which he was the founder and from which he received an annual salary of $19,000. (R. 169-170.)

In addition to respondent's original investment of $38,900 in Kelly-Generes, he personally advanced it funds from time to time to enable it to complete construction jobs. He also guaranteed loans made to the corporation by various banks for the purpose of purchasing construction machinery and other equipment. In 1962, when the corporation was in serious financial difficulties, respondent advanced it $158,814.49, which he obtained by mortgaging some of his properties to a local bank. (R. 58-59, 63-65, 71-72, 170.)

The construction contracts undertaken by Kelly-Generes necessitated performance and payment bonds, the greatest number of which were obtained from the Maryland Casualty Company. Casualty, in turn, required respondent to sign separate indemnity agreements with it for each bond issued to the company. Late in 1958, to obviate the need for separate indemnity agreements for each construction job, respondent and Kelly, in their individual capacities and for the corporation, each signed a "Blanket Indemnity Agreement" with Casualty, wherein they agreed to indemnify Casualty for any losses it suffered as surety for Kelly-Generes up to $2,000,000. (R. 170-171.)

In 1962, Casualty was required to complete performance on two Kelly-Generes contracts, and pursuant to the agreement, respondent indemnified Casualty for $162,104.57. Although subrogated to Casualty's rights as a creditor, he was unable to collect the amount of the indemnity from Kelly-Generes due to its subsequent bankruptcy. He was also unable to collect the $158,814.49 he had advanced to Kelly-Generes in direct loans. (R. 63-65, 171.)

On his federal income tax return for 1962, respondent treated the loss on the direct loans as a nonbusiness bad debt. However, he deducted the $162,104.57 indemnification loss against ordinary income as a business bad debt, and subsequently filed claims for refund for 1959 through 1961 based upon net operating loss carrybacks to those years in the amount of the unused portion of the business bad debt deduction. The Commissioner paid the carryback claim under the "quick" refund

procedure prescribed in Section 6411 of the Internal Revenue Code. Subsequently, on audit, he disallowed the net operating loss carrybacks on the ground that respondent's payment to Casualty gave rise to a deduction for a nonbusiness bad debt. Such a debt is defined in Section 166(d)(2) of the Internal Revenue Code as a debt other than—

> (A) * * * a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
>
> (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

Under Section 166(d)(1) a deduction for a nonbusiness bad debt is treated as a short-term capital loss, and pursuant to Section 172, may not be carried back as a net operating loss.[3] Respondent paid the tax in dispute and thereafter brought this suit for refund in the district court. (R. 65, 171-172.)

At trial before a jury, respondent testified (R. 67) that his sole motivation for signing the indemnity agreement was to protect his $12,000-a-year job with Kelly-Generes. As for his investment in the corporation (consisting of both his stock interest and loans),

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[3] Section 172(d)(4) provides that any excess of nonbusiness deductions over nonbusiness income is not to be taken into account in computing the net operating loss deduction. Consequently, unless respondent's bad debt deduction is characterized as a business bad debt, he may not use it to offset his business income for 1959, 1960 and 1961.

he professed (R. 67), "No, I never once gave it a thought."

At the close of all the evidence, the court denied both parties' motions for directed verdicts. (R. 93, 131). By special interrogatory, the jury was asked (R. 115) to determine whether the signing of the blanket indemnity agreement by respondent was, as required by the Treasury regulations as a prerequisite to business bad debt treatment, proximately related to his trade or business of being a Kelly-Generes employee. In this regard, the district court charged the jury, over the government's objection (R. 127), that (R. 119, 121):

> A debt is proximately related to the taxpayer's trade or business when its creation was *significantly motivated* by the taxpayer's trade or business, and it is not rendered a non-business debt merely because there was a non-qualifying motivation as well, *even though the non-qualifying motivation was the primary one.* [Emphasis added.]
>
> * * * *
>
> A debt is a business bad debt if the debt, or the activity giving rise to the debt, is such that without the taxpayer assuming or acquiring it his trade or business would no longer be able to operate in the manner in which it is intended to operate.

The court refused the government's express request (R. 127) that the following instruction be given instead (R. 159):

> You must, in short, determine whether Mr. Generes' dominant motivation in signing the indemnity agreement was to protect his salary and status as an employee or was to protect his investment in the Kelly-Generes Construction Co.
>
> * * * It is insufficient if the protection or insurance of his salary was only a significant secondary motivation for his signing the indemnity agreement. It must have been his *dominant or most important reason for signing the indemnity agreement*. [Emphasis added.]

The jury, after encountering some difficulty with the court's instructions (R. 129-131) found (R. 131) that respondent's undertaking was proximately related to his trade or business of being an employee. The government moved for judgment n.o.v. and alternatively for a new trial (R. 164-166). Upon denial of these motions (R. 166), judgment on the verdict was entered for respondent (R. 167). A divided court of appeals affirmed, holding that the jury had been properly instructed.

SUMMARY OF ARGUMENT

Section 166 of the Internal Revenue Code provides that an individual taxpayer may deduct a bad debt against ordinary income only if the debt is created or acquired in connection with, or the loss therefrom is incurred in, the taxpayer's trade or business. Otherwise, the deduction is for a nonbusiness bad debt, deductible only as a short term capital loss. The problem here arises where a taxpayer bears a dual relationship

—as shareholder and also as employee—to the corporation whose default gives rise to a bad debt loss. While his employee status constitutes a "trade or business," so that a loss bearing the required degree of relationship to such status is deductible in full (*Trent* v. *Commissioner,* 291 F. 2d 669 (C.A. 2)), his shareholder status is not a "trade or business." Losses on loans or guarantees made to advance a taxpayer's status as an equity owner accordingly are deductible only as nonbusiness bad debts. *Whipple* v. *Commissioner,* 373 U.S. 193. See also *Putnam* v. *Commissioner,* 352 U.S. 82. In the dual status situation, the bad debt must be characterized in its entirety as business or nonbusiness in nature, even though the taxpayer may have been motivated to some extent both by his investment (nonbusiness) interest and by his employee(business) interest to lend money to, or guarantee the debts of, his corporation.

I

The holding below paradoxically allows a bad debt to be treated as a business deduction in a situation where the principal or dominant reason for creating the debt was a nonbusiness reason. This holding is at odds with settled principles requiring that tax consequences be governed by reference to the taxpayer's dominant motivation in cases which Congress and this Court consider directly related to the situation here. Thus, for example, dominant motivation is controlling where a taxpayer purchases an equity interest for both business and investment (nonbusiness) reasons or where he acquires an asset for both business and personal rea-

sons, and subsequently suffers a loss. With respect to the former situation, this Court has held that the non-business bad debt provision was designed to make the tax treatment of losses on loans parallel to the treatment of losses on equity interests. With respect to the latter, the relevant committee reports state that the same standards should be used in determining whether a debt was a business bad debt as are applicable in determining whether a loss on an asset was incurred in a trade or business. Pertinent Treasury regulations reiterate this congressional direction. In short, the plain import of the statute, its history and the Treasury interpretation require that the dominant motivation standard be applied here.

The provision in the regulations authorizing business bad debt treatment if the loss on worthlessness of a debt is "proximately" related to the taxpayer's trade or business does not support adoption of the significant motivation standard as the court below thought. The notions of proximate causation from tort law on which the Fifth Circuit majority relied have no bearing on the resolution of the federal income tax problem which this case presents.

This Court's opinion in *Whipple* v. *Commissioner, supra,* argues strongly against the result reached below. The Court there indicated that a shareholder-employee who was barred from ordinary deduction treatment because his investment activities did not constitute a business, would find it difficult to prove that the loss on his debt was proximately related to his trade or business of being an employee. But there is no great difficulty

of proof under the significant motivation standard. As the instant case itself illustrates, where respondent's salary of $12,000 a year was found to have motivated a potential liability of $2,000,000, that standard opens the possibility that a shareholder-employee will be able to obtain an ordinary deduction merely by introducing testimonial evidence that his undertaking was motivated in some degree by his trade or business.

The Court contemplated in its *Whipple* opinion that a careful choice would be made in characterizing the bad debt deduction of a shareholder-employee as a business or nonbusiness deduction. The significant standard, which requires the jury to apply a vague and undefined concept, does not permit such a choice.

II

Even if the significant motivation standard is proper, we contend that under any workable definition of that term there was no such motivation in the instant case. Although the district court failed to define significant, leaving it to the jury to determine just what that term contemplates, it surely requires nothing less than some reasonable connection between the amount of the taxpayer's salary as an employee and the magnitude of the financial risk which he was motivated to take. When respondent's part-time salary of $12,000 a year is compared with the possible $2,000,000 in liability to which he subjected himself by signing the indemnity agreement, the conclusion is inescapable that he was not even significantly motivated by his employment to indemnify his corporation's surety.

ARGUMENT

I. A SHAREHOLDER-EMPLOYEE IS ENTITLED TO A BUSINESS RATHER THAN NONBUSINESS BAD DEBT DEDUCTION, ARISING OUT OF THE INABILITY TO COLLECT A DEBT OWED HIM BY HIS CORPORATION, ONLY IF THE DOMINANT MOTIVATION FOR THE UNDERTAKING WAS HIS EMPLOYEE INTEREST RATHER THAN HIS INVESTMENT INTEREST AS A SHAREHOLDER

A. The Problem in Perspective

This is the third occasion in a decade and a half on which this Court has been called upon to resolve a conflict in the circuits involving the nonbusiness bad debt deduction allowed by Section 166 of the Internal Revenue Code (Appendix, *infra,* pp. 35-36) and its 1939 Code predecessor. Because business bad debts are deductible from ordinary income while nonbusiness bad debts are treated as short-term capital losses, taxpayers have sought in a variety of ways to avoid the less favorable nonbusiness classification. In the two prior cases before this Court, taxpayer attempts to restrict the coverage of the nonbusiness bad debt provision were unsuccessful. *Putnam* v. *Commissioner,* 352 U.S. 82; *Whipple* v. *Commissioner,* 373 U.S. 193.

Although, as will be seen, the arguments advanced in those cases were different from each other and from the arguments advanced here, the factual patterns of the three cases are similar and present the typical setting in which business-nonbusiness bad debt problems arise. In each of the cases a dominant or major shareholder advanced money to, or paid money as a result of his having guaranteed the debts of, his corporation and was subsequently unable to collect these funds from the corporation. And, in each, he sought an ordinary, rather than a capital, deduction.

In order for a bad debt to be treated as a business deduction, the pertinent Treasury regulations (Section 1.166-5(b), Appendix, *infra,* pp. 36-37), in line with the committee reports on the 1939 Code predecessor of Section 166, require the relationship between the conduct of the trade or business and the loss from the debt to be "proximate." Thus, to qualify a debt for an ordinary deduction under Section 166(d), a taxpayer must establish (1) that he is engaged in a business, and (2) that the bad debt loss was proximately related to that business.

In *Putnam* v. *Commissioner, supra,* decided in 1956, the taxpayer, a guarantor of corporate obligations, attempted to avoid both of these requirements. He contended that the character of his losses should be determined not by reference to the predecessor of Section 166(d), but under the predecessor of Section 165(c)(2) (Appendix, *infra,* p. 35). That section permits deductions for "losses incurred in any transaction entered into for profit, *though not connected with a trade or business* * * *."[4] (Emphasis added.) The Court rejected the taxpayer's claim to ordinary loss treatment. It held that losses sustained by a guarantor who is subrogated to the rights of his corporation's creditor are by their very nature bad debt losses, and hence, under the rules of the 1939 Code counterpart of Section

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[4] The Court has discussed the differences between mere profit-seeking activities, on the one hand, and those that constitute a trade or business, on the other, in *Trust of Bingham* v. *Commissioner,* 325 U.S. 365, 373-374. See also *Deputy* v. *DuPont,* 308 U.S. 488; *Higgins* v. *Commissioner,* 312 U.S. 212.

166(d), may be deducted from ordinary income only if incurred in a trade or business.

Seven years later, in *Whipple* v. *Commissioner, supra,* the Court was faced with a claim involving the first of the two requirements of the regulations under Section 166(d). The taxpayer there argued that the mere furnishing of organizational, promotional and managerial services by a corporate shareholder constituted a trade or business, so that bad debts suffered in connection with such activities could be deducted as business bad debts. But the Court held otherwise, concluding (373 U.S. at 202) that "[d]evoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged" and (*ibid.*) that "investing is not a trade or business." Any other conclusion, the Court reasoned (*id.* at 203), would be inconsistent with the established principle that a corporation has a personality separate from that of its shareholders and its business is not their business. See, *e.g., Dalton* v. *Bowers,* 287 U.S. 404; *Burnet* v. *Clark,* 287 U.S. 410.

In the wake of the decision in *Whipple,* the attention of the tax bar turned finally to the second requirement of the regulations for business bad debt treatment—that the loss on the debt be "proximately" related to the taxpayer's business. Relying on settled law that a salaried employee is engaged in the trade or business of being an employee,[5] shareholders have attempted to

[5] See, *e.g., Batzell* v. *Commissioner,* 266 F. 2d 371 (C.A. 4); *Roberts* v. *Commissioner,* 258 F. 2d 634 (C.A. 5); *Pierce* v. *United States,* 254 F. 2d 885 (C.A. 9); *Overly* v. *Commissioner,* 243 F. 2d 576 (C.A. 3); *Folker* v. *Johnson,* 230 F. 2d 906 (C.A. 2).

obtain the result denied them in *Whipple* on the theory that their loans or guarantees were motivated by a desire to protect their salaried position with their corporation, and thus were proximately related to their business.[*]

Is a shareholder-employee entitled to business bad debt treatment on a showing that, in making a loan to his corporation, or in guaranteeing its debt, he was significantly motivated by a desire to protect his salaried position, even though concern for his investment in the corporation may have been the primary reason for the undertaking? The district court (R. 119) and the Fifth Circuit (R. 173-174) in the present case, and the Second Circuit in *Weddle* v. *Commissioner,* 325 F. 2d 849, have held in such circumstances that the requisite proximate relationship exists. Or is business bad debt treatment appropriate only where protection of the salaried position is the dominant motivating force? That is the conclusion of the Seventh Circuit and of the Tax Court in a unanimous reviewed opinion. *Niblock* v. *Commissioner,* 417 F. 2d 1185; *Smith* v. *Commissioner,* 55 T.C. 260.

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[*] As of the time we filed our petition in this case, 179 cases were pending at the appellate conference level of the Internal Revenue Service, involving more than $4,000,000 of tax, in which shareholder-employees were claiming business bad debt deductions on the ground that the debts were incurred in the trade or business of being a corporate employee.

B. The logical and necessary import of Section 166 as well as the committee reports and Treasury regulations require adoption of the dominant motivation standard

Section 166(d) does not provide for a division of a bad debt deduction into ordinary and capital portions where the taxpayer's undertaking was motivated by both business and nonbusiness considerations. Like many other provisions of the Code which preclude an allocation in situations where qualifying and nonqualifying factors are present (*e.g.,* Section 165(c)(1) and (2), Appendix, *infra,* p. 35), Section 166(d) prescribes an all-or-nothing situation. Either a bad debt loss is "incurred in" the taxpayer's trade or business, or it is incurred in his nonbusiness (investment or personal) activities.[7] Thus, in an instance where both business and nonbusiness considerations are present, the statute requires that a choice be made. Presumably, in every case where a stockholder who is also a salaried officer or employee seeks to assist or save his corporation by

[7] Section 166(d)(2)(A) was added to the Code in 1954. It provides that a business bad debt may be "created or acquired in connection with" a trade or business. In enacting this provision, Congress did not intend to relax the required relationship which previously had to be established between the debt and the trade or business under the "incurred in" language now appearing in Section 166(d)(2)(B). The new subsection was included solely for the purpose of adding to the category of business bad debts those debts which, although sufficiently related to the taxpayer's trade or business at the time they were created or acquired, were not so related at the time they proved uncollectible because the taxpayer had by that time gone out of business. H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 21-22; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 24.

making or guaranteeing loans to it, he will be motivated to some degree by his investor interest and to some degree by his interest in the continuation of his salary. But one of the considerations must control or dominate the outcome for tax purposes, even though both may have had some operative effect.

The objection which inheres in the significant motivation test, adopted by the court below and by the Second Circuit in *Weddle* v. *Commissioner*, 325 F. 2d 849, is that it permits the business consideration to control the tax result where the nonbusiness consideration is the predominant motivating factor. Indeed, this test would permit the business consideration to control even where the taxpayer would not have made the loan if the business motivation had been his sole motivation, but would have done so with only the investment motivation. No apparent reason why this should be so emerges from the statute, the regulations or the legislative history.

To permit a taxpayer whose primary reason for assuming the risk of a bad debt loss is personal or investment-oriented to treat the loss as a "trade or business" deduction is contrary to the very structure of the Internal Revenue Code. If the primary motivation is personal—for example, where a taxpayer makes a loan to his landlord to prevent a foreclosure on the property and the subsequent loss of the taxpayer's apartment—permitting the taxpayer a business deduction would greatly diminish the force of the mandate of Section 262 that "no deduction shall be allowed for personal, living, or family expenses" except as otherwise provided in

the Code. In fact, one of the reasons for the enactment of the 1939 Code predecessor of Section 166(d) in 1942 was to prevent taxpayers from making loans to their relatives which they never expected to be repaid, and then deducting the unrepaid loans as losses against ordinary income.[8] The new law was designed to make such unrepaid loans deductible, if at all, only as nonbusiness bad debts. H.Rep. No. 2333, 77th Cong., 2d Sess., p. 45; see *Putnam* v. *Commissioner, supra* at 91. Yet, in direct conflict with the stated congressional purpose, the significant motivation standard would permit a taxpayer who was primarily motivated by his personal interest to see his son-in-law's business prosper and only secondarily motivated by the prospect of such business paying him a salary, to take a business bad debt deduction if the business subsequently failed to repay the loan.

In similar fashion, if the choice is between an investment consideration and a trade or business consideration, the legislative purpose of Section 166(d) would seem to dictate that the dominant or primary consideration control the tax result. In *Putnam* v. *Commissioner, supra,* this Court stated (352 U.S. at 92) that an equally important reason for the enactment of the 1939 Code predecessor of Section 166(d) was—

> to put nonbusiness investments in the form of loans on a footing with other nonbusiness investments. * * * The loss [a taxpayer] sustained when his

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[8] Under the pre-1942 law, there was no provision for nonbusiness bad debt deductions, and all bad debt losses were deductible from ordinary income.

stock became worthless, as well as the losses from the worthlessness of the loans he made directly to the corporation, would receive capital loss treatment; the 1939 Code so provides as to nonbusiness losses both from worthless stock investments and from loans to a corporation, whether or not the loans are evidenced by a security. * * *

It is well established that a shareholder who loses his equity investment in a corporation would not be permitted to take an ordinary business loss merely by showing that, although his dominant purpose in acquiring the stock was as a capital investment, he was to a lesser degree motivated by "business" reasons. See, *e.g.*, *Commissioner* v. *Bagley & Sewall Co.*, 221 F. 2d 944 (C.A. 2); *Booth Newspapers, Inc.* v. *United States*, 303 F. 2d 916 (Ct. Cl.); *Waterman, Largen & Co., Inc.* v. *United States*, 419 F. 2d 845 (Ct. Cl.), certiorari denied, 400 U.S. 869; *Steadman* v. *Commissioner*, 424 F. 2d 1 (C.A. 6), certiorari denied, 400 U.S. 869; *Western Wine & Liquor Co.* v. *Commissioner*, 18 T.C. 1090. Indeed, while some courts have applied the dominant motivation standard in this context (*e.g.*, *Waterman, Largen & Co., Inc.* v. *United States*, *supra* at 854), others have applied an even stricter standard and have allowed ordinary loss treatment only where no investment motivation was present (*e.g.*, *Booth Newspapers, Inc.* v. *United States*, *supra* at 921).[9] Given the legis-

[9] These cases involved a corporation or sole proprietorship which alleged that its investment in another corporation's stock was for the purpose of furthering its own business rather than to make a

lative purpose of Section 166(d) as elaborated by this Court in *Putnam*, and the body of case law dealing with equity investments as trade or business expenses, it should follow that a bad debt loss which is incurred first for investment reasons and only secondarily for business reasons does not qualify as a trade or business bad debt deduction.

The Treasury regulations, adopting the language of the committee reports on the 1939 Code section which preceded Section 166(d) (H.Rep. No. 2333, 77th Cong., 2d Sess., pp. 76-77; S. Rep. No. 1631, 77th Cong., 2d Sess., p. 90), also support our position. Section 1.166-5 (b)(2) of the regulations provides in part that:

> The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in

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profitable investment. (While the government has contended that the element of motivation should not remove such investments from the capital asset category, the courts that have looked to motivation have required that it at least be primary or dominant.) This precise situation also arises in the bad debt area, when a sole proprietorship lends money to a corporation in which it already has an equity investment, and alleges that the ensuing bad debt loss was motivated by a business relationship between the two (*e.g.*, purchaser-supplier) rather than to protect the stock investment. See *Lundgren* v. *Commissioner*, 376 F. 2d 623 (C.A. 9); *Mays* v. *Commissioner*, 272 F. 2d 788 (C.A. 6); *Smith* v. *Commissioner*, 55 T.C. 260; *Estate of Saperstein* v. *Commissioner*, P-H T.C. Memo, par. 70,209. The inquiry in these dual status business-relation-shareholder cases is the same as that made in the dual status employee-shareholder cases.

> a trade or business for purposes of section 165(c) (1).

Under Section 165(c)(1) the courts have consistently rejected any contention that a minor business orientation in a transaction giving rise to a loss would entitle a taxpayer to a business deduction, if the principal reason for his entering into the transaction was a non-business reason. The primary intent or motive has always been the ultimate test for determining whether losses are deductible because incurred in a trade or business. See, *e.g., Imbesi* v. *Commissioner,* 361 F. 2d 640 (C.A. 3); *Coffey* v. *Commissioner,* 141 F. 2d 204 (C.A. 5); cf. *Hirsch* v. *Commissioner,* 315 F. 2d 731 (C.A. 9).[10]

Likewise, in determining whether a loss has been incurred in a transaction entered into for profit under Section 165(c)(2), the taxpayer's principal or dominant motive has been held controlling. In *Austin* v. *Commissioner,* 35 T.C. 221, affirmed, 298 F. 2d 583 (C.A. 2), the Tax Court, in denying a deduction on a sale of real property, found that the property was originally purchased primarily for a residence and only secondarily to make a profit. On appeal, the taxpayer contended that since the word "primarily" does

[10] The fact that the Section 165(c) cases cited above involved nonbusiness motivations which are personal rather than investment-oriented does not render these cases any less applicable to the instant case where the distinction is between investment and business motivation. As noted above, one of the legislative reasons for the enactment of the predecessor of Section 166(d) was to distinguish between those loans made for personal reasons to relatives and those made for business reasons. These cases are therefore directly in point here.

not appear in Section 165(c)(2), and since the Tax Court found that the transaction was entered into for profit, the deduction must be allowed. In affirming the Tax Court's decision, the court of appeals noted (p. 584):

> The statute makes no provision for the apportionment of the loss when a transaction is entered into both to satisfy a personal or family need and to make a profit. A primary motive of acquiring a family residence brings the purchase within the ambit of § 262 of the Internal Revenue Code, 26 U.S.C.A. § 262, which provides that "no deduction shall be allowed for personal, living, or family expenses." The logical interrelation of § 165 and § 262 requires a decision as to which of the two motives was dominant, so that one or the other section can be applied. And the decisions of the Supreme Court and of this court have been consistent with this result. In Helvering v. National Grocery Co., 304 U.S. 282, 289 note 5, 58 S. Ct. 932, 936, 82 L. Ed. 1346 (1938), the Supreme Court said: "[T]he deductibility of losses under [§ 165 (c)] may depend upon whether the taxpayers' motive in entering the transaction was primarily profit." * * *

Clearly, then, if the mandate of the regulations and the committee reports is to have any meaning, it must be that in determining whether or not bad debt losses have

been incurred in a trade or business, the dominant or primary motive of the taxpayer is controlling.[11]

In rejecting the dominant motivation standard, the court below, citing the majority opinion in *Weddle* v. *Commissioner,* 325 F. 2d 849 (C.A. 2), relied on that portion of Section 1.166-5(b)(2) of the regulations which provides that if a loss resulting from the worthlessness of a debt bears a "proximate" relationship to the taxpayer's trade or business, it may be deducted as a business bad debt loss. According to the Second Circuit in *Weddle* (p. 851):

> In the law of torts, where the notion of "proximate" causation is most frequently encountered, a cause contributing to a harm may be found "proximate" despite the fact that it might have been "secondary" to another contributing cause. See 2 Harper & James, The Law of Torts, §§ 20.2 and 20.3; American Law Institute, Restatement, Torts, §§ 432(2), 433, 439, 875, 879 (1939); Restatement Second, Torts, §§ 443A at 54 (Tent. Draft No. 7, 1962), § 442B at 29 (Tent. Draft No. 9, 1963). * * *

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[11] The problem of what degree of motivation or purpose should be determinative of tax consequences has been before this Court in a variety of contexts. See, *e.g., Helvering* v. *National Grocery Co.,* 304 U.S. 282; *Commissioner* v. *Duberstein,* 363 U.S. 278; *United States* v. *Kaiser,* 363 U.S. 299; *United States* v. *Donruss Co.,* 393 U.S. 297. We do not deal with these cases here because "[t]hey deal with areas of the Code whose language, purpose and legislative history are entirely different from those of the" statute with which we are now concerned. *United States* v. *Donruss Co., supra* at 309.

Neither the Second nor the Fifth Circuit has furnished any reason why tort law principles should control for federal tax purposes. Since the term "proximate" appears in the same section of the regulations which equates the business-nonbusiness bad debt determination with a Section 165(c)(1) determination, the use of that term is not intended to permit a different standard for business connection from that which applies under Section 165(c)(1). Moreover, the commentators have emphasized that the notion of "proximate cause" as defined and developed in tort cases is a conclusional term used to describe a particular result, rather than how the result is reached. See Prosser, *The Law of Torts* (2d ed., 1955), p. 252.

The determination of proximate cause in tort law is based upon considerations such as duty and forseeability (Prosser, *supra*, c. 9), which are peculiar to tort law, and are certainly of no relevance to the federal tax problem involved here. In this respect, it should be noted that the Restatement of Torts, upon which the Second Circuit relied in part for its definition of "proximate cause," does not employ the word "proximate" in any of its sections.[12] Presumably recognizing that, as used in tort law, "proximate" is a conclusional term employed to denote those factors which are legally responsible for a particular result, the Restatement substitutes the term "legal cause" in its place. See Restatement Torts, Section 431; Restatement Torts 2d,

[12] Those sections of the Restatement cited by the Second Circuit define the term "legal cause" rather than "proximate cause."

Section 431. It is in this context that Comment (d) to Section 430 of the Restatement 2d states:

> In order that a negligent actor may be liable for harm resulting to another from his conduct, it is only necessary that it be a legal cause of the harm. It is not necessary that it be *the* cause, using the word "the" as meaning the sole and even the predominant cause. * * *

Determination of legal cause within the realm of tort law obviously involves different considerations from those involved in determining whether, for tax purposes, a trade or business was the legal cause of a particular bad debt loss. A single choice between alternatives is not necessary in tort law because more than one actor may be found responsible, and joint or several liability may be imposed. Thus, the typical legal cause problem in torts is concerned with a chain of successive factors, each contributing in some way to the ensuing damage. Each factor must be a *sine qua non,* a cause in fact, but for which the damage would not have occurred. 2 Harper & James, *The Law of Torts,* § 20.2, p. 1110. The question then becomes, which causes along the chain will be deemed substantial enough to be labelled legally responsible.

Under Section 166(d), on the other hand, we deal with the complexities of human motivation, and attempt to weigh different motives not necessarily acting in sequence, so that we can ultimately determine which *one* of those motives should be given controlling effect. It is possible that only one of the motives was the caus-

ative factor, but for which the bad debt would not have been incurred. It is also possible that neither alone was strong enough to motivate the loan, and finally, it is possible that either alone would meet the but for test.[13] But, unlike tort law, which would allow both to be labelled legal causes, Section 166(d) requires a choice between the two.

Since, as we have shown, the logical import of the statute, as well as the committee reports and the language of the regulations indicate that the choice should be made on the basis of which of the two factors was predominantly or primarily responsible for the loan, the use of the term "proximate" should not confuse the issue. It should be interpreted to give effect to the clear

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[13] Although the Second Circuit in *Weddle* found tort law controlling in defining "proximate cause" as "significant," it completely ignored the fact that a common thread running through all the diverse theories of "proximate cause" for tort purposes is that the alleged cause must meet the "but for requirement." 2 Harper & James, *The Law of Torts, supra.* One must be able to say that "but for" the defendant's act, the harm would not have occurred. Applying this necessary element of proximate cause, as it is defined in tort law, to Section 166, the taxpayer would be required to show that but for his salaried position with the corporation, he would not have made the loan. (It is doubtful that such a showing could have been made in the instant case where, for an annual salary of $12,000, respondent incurred a potential liability of $2,000,000 by virtue of his signing the idemnity agreement.) Thus, even in a situation where the salary interest was the dominant motivation, it is possible that under tort law's but for test, it would not be the proximate cause, if it alone without the investment interest would not have motivated the loan. In this connection see the test proposed by Stahl, J. in a separate opinion (dissenting from the majority on another issue) in ***Stratmore* v. *United States***, 420 F. 2d 461 (C.A. 3), certiorari denied, 398 U.S. 951.

congressional and administrative mandate, and not by reference to unrelated concepts applicable in tort law.

C. The significant motivation standard is incompatible with the principles announced by this Court in Whipple

In the *Whipple* case, it was unnecessary for the Court to address itself squarely to the Section 166(d) problems that arise when a taxpayer bears a dual relationship to a corporation. But, Mr. Justice White, speaking for the Court and anticipating these problems, stated his understanding to be that a shareholder would not be able to obtain business bad debt treatment merely because he was also a corporate employee.[14] He admonished, prophetically for the instant case, that (373 U.S. at 202):

> Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business.

Contrary to the principles announced in *Whipple,* the significant motivation standard offers an easy route to business bad debt benefits for many corporate investors

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[14] The Court thus disposed of any claim the taxpayer might have had because he was an employee. It remanded the case for further proceedings to determine whether the bad debt sustained by the taxpayer, who was also the landlord of the defaulting corporation, was "proximately related" to his trade or business as landlord (373 U.S. at 204-205).

in closely held corporations, and invites circumvention of the holding in *Whipple* itself. See *Weddle* v. *Commissioner,* 325 F. 2d 849, 852-853 (Lumbard, J., concurring). We need go no further than the instant case to demonstrate this, as Judge Simpson recognized in his dissent (R. 177). On the bare self-serving testimony by respondent that he was motivated by his salaried position paying $12,000 a year to indemnify his corporation's surety up to $2,000,000, the jury found that he was entitled to business bad debt treatment.

Respondent seems to contend (Br. in Opp. 7, 9) that the significant, rather than the dominant, motivation standard should apply to him because he was not, within the meaning of this Court's language in *Whipple* (373 U.S. at 204), "the sole or dominant shareholder" of Kelly-Generes. There is no merit to this contention. The same standard of proof applies to all shareholders—one that may make it difficult for sole or dominant shareholders to establish entitlement to the more favored treatment. Only the dominant motivation standard meets this requirement.[15]

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[15] Respondent mistakenly suggests in his brief in opposition (p. 7) that although it may be appropriate to apply the dominant standard to cases involving loans by shareholder-employees, the significant standard is applicable in guarantee cases. Where, as in this case, the shareholder is subrogated to the rights of the creditor (R. 171), *Putnam* v. *Commissioner,* 352 U.S. 82, requires that his right to business bad debt treatment be determined in the same manner as if he had made a loan. Likewise erroneous is respondent's claim (Br. in Opp. 7, 9) that the significant standard should apply here because it is common for a shareholder-employee of a corporation required to post performance bonds in *its* business to indemnify his corporation's surety. Any such argument is foreclosed by this Court's decision in *Whipple.*

Furthermore, even if a different standard of motivation were justifiable for differently situated shareholders, respondent surely would not be entitled to the benefit of the more lenient standard. He stresses (Br. in Opp. 7-9) that he was not the controlling shareholder of Kelly-Generes. To be sure, he owned 44 percent of its stock, less than a majority. But this is not a situation where the remaining stock was in the hands of adverse parties. On the contrary, it was all *en famille,* and the record is barren of any evidence of hostility among the members of the family.

The "care" which this Court said "must be taken" (373 U.S. at 202) in distinguishing the bad debt losses arising from the taxpayer's business and those arising from his investment activities can only be taken if the dominant motivation standard is applied. This is so because the significant standard is both absolutely and relatively imprecise. Under that standard, as approved by the Second Circuit in *Weddle* v. *Commissioner, supra,* and by the court below, the jury is asked simply whether the taxpayer's employee motivation was, in the circumstances, significant. Although this Court's opinion in *Whipple* would seem to require that the term at least be given some quantitative or relative content, we know of no instance in which a court has undertaken this task, nor any basis on which it could be done.

This objection to the significant standard is not merely theoretical. The proceedings in the district court in the instant case show clearly that the jury was unable to make the kind of discriminating analysis contemplated by the *Whipple* opinion. After the court had

instructed the jury in the manner requested by respondent, the foreman found it necessary to return not once, but twice, for clarifying instructions (R. 129-131). On both occasions he was sent back to the jury room with instructions which did not give any quantitative or relative content to the significant standard and which, therefore, were of dubious assistance. The jury was left to decide for itself not only whether a significant business motivation was present but, in addition, the quantum of motivation necessary to establish significance. It is undoubtedly for this reason that the Court of Appeals for the Seventh Circuit concluded in *Niblock* v. *Commissioner,* 417 F. 2d 1185, 1187, that "the only test that will inject sufficient certainty into the interpretation of section 166 is the dominant and primary motivation test that we have stated." See also *Weddle* v. *Commissioner, supra* at 852-853 (Lumbard, J., concurring); *Smith* v. *Commissioner,* 55 T.C. 260, 270.

The dominant standard is at once easily understandable by a jury—it need only determine which of the motivations was the stronger—and can be applied meaningfully by reference to objective facts. The jury can compare the amount risked by the shareholder-employee with the potential returns from his salaried position. It can then compare the risked amount with the potential investor's rewards (dividends and capital appreciation), coupled with the size of the shareholder-employee's existing capital investment which might be saved by the additional financing. In a family situation such as the present one, it can also take into ac-

count the taxpayer's possible purpose to protect or further the interests of his sons-in-law and son, which are not *his* business interests. The issue would be determined by whether the business or nonbusiness motivation was the weightier. A taxpayer's testimony would be taken not simply to permit him to assert that he was motivated by his employee interest, but to develop the objective facts and to allow him to explain the specific manner in which he purports to have been influenced by them. This type of inquiry, and not that sanctioned by the court below, most closely comports with the principles enunciated in *Whipple.*

II. IF, IN THE ALTERNATIVE, A SIGNIFICANT EMPLOYEE MOTIVATION IS SUFFICIENT TO JUSTIFY BUSINESS BAD DEBT TREATMENT, UNDER ANY WORKABLE DEFINITION OF THAT TERM THERE WAS NO SUCH MOTIVATION IN THIS CASE

Although both the Second and Fifth Circuits have adopted the significant motivation standard, neither court has been able to furnish a workable definition of that term. As we have pointed out, since the quantum of motivation necessary to constitute significant was not articulated by the district court in the present case, the jury was left to determine for itself precisely what the standard contemplates. We submit that under any workable definition of the term significant, the facts of this case, viewed in the light most favorable to respondent, do not establish his entitlement to business bad debt treatment.[16]

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[16] The only portion of the jury instructions which could be taken as shedding some light on the significant standard was as follows (R. 121):

> A debt is a business bad debt if the debt, or the activity giving rise to the debt, is such that without the taxpayer assuming or

At the very least, the significant motivation standard requires a reasonable relationship between the amount of the taxpayer's salary as an employee of his corporation and the magnitude of the financial risk involved in the loan to, or the guarantee for the benefit of, the corporation. It would, indeed, strain the imagination to believe that respondent, who had a separate full-time job paying $19,000 a year and liquid assets in the form of bank deposits ranging from $30,000 to $55,000 during the period in issue (R. 70), was so concerned about his $12,000 a year job with Kelly-Generes that he risked over $2,000,000 in liability by signing the indemnity agreement. Moreover, respondent has failed to show that he could not secure the same employment elsewhere at a comparable salary, rather than risk the $2,000,000 in personal liability. Cf. *Jaffee* v. *Commissioner*, P-H T.C. Memo., par. 67,215.

Respondent's nonbusiness motivations, on the other hand, were overwhelming. To begin with, he had substantial sums of money tied up in the corporation in the form of equity and loans. He had made an original

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> acquiring it his trade or business would no longer be able to operate in the manner in which it is intended to operate.

This instruction, however, is clearly faulty and would alone be grounds for reversal here. It would allow business bad debt treatment whenever a shareholder has a job for any salary with his corporation, which would necessarily be terminated upon the corporation's failure. He could *easily* show that without the loan to his corporation, his trade or business as an employee would cease to operate. Such a showing, however, is not sufficient to qualify losses for business bad debt treatment under the decisions of the Fifth Circuit itself. See *Kelly* v. *Patterson*, 331 F.2d 753; *United States* v. *Worrell*, 398 F.2d 427.

investment of $38,900 in the enterprise, and at the time the corporation went bankrupt, it was indebted to him on direct loans amounting to more than $158,000 (R. 58-59, 63-65, 71-72). There was, moreover, the prospect, or at least the hope, of future capital growth. Finally, the corporation was a family business in which respondent's son and sons-in-law had substantial interests. One son-in-law (Kelly) owned 44 percent of the corporation's stock and was employed by it full-time. The existence of personal reasons for guaranteeing the corporation's debt, in addition to the investment reasons, therefore, cannot be denied.

In sum, no matter how the term significant is interpreted, there is no adequate factual basis for the conclusion that respondent was significantly motivated by his interest as an employee to indemnify his corporation's surety. Such a conclusion is all the more implausible in view of respondent's failure to claim business bad debt treatment with regard to his direct loans of over $158,000 to Kelly-Generes (R. 64-65). Certainly, there is nothing in the record that suggests one motivation for the loans and another for the indemnification agreement.

CONCLUSION

The judgment of the court of appeals should be reversed and the cause remanded to that court with direction to enter judgment for the government, if it should appear under the standard established by this Court that the government is entitled to judgment n.o.v. Alternatively, the cause should be remanded to the dis-

trict court for a new trial, with direction to grant the government's requested instruction.

Respectfully submitted.

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MAY 1971.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 165. LOSSES.

* * * *

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; * * *

* * * *

SEC. 166. BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * * *

(d) *Nonbusiness Debts.*—

(1) *General rule.*—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) *Nonbusiness debt defined.*—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) [as amended by Sec. 8, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * * * *

Treasury Regulations on Income Tax (26 C.F.R.):
§ 1.166-5 *Nonbusiness debts.*

* * * * *

(b) *Nonbusiness debt defined.* For purposes of section 166 and this section, a nonbusiness debt is any debt other than—

* * * * *

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular

case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See § 1.165-5, relating to losses on worthless securities.

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IN THE

Supreme Court of the United States

OCTOBER TERM 1970

70-28

~~No. 883~~

UNITED STATES OF AMERICA,
Petitioner,

versus

EDNA GENERES, Wife of, and ALLEN H. GENERES,
Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

BRIEF FOR RESPONDENTS

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